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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

*Economic and Political Factors
in East-West German Trade*

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
10 January 1968

INTELLIGENCE MEMORANDUM

Economic and Political Factors
in East-West German Trade

Summary

Trade between East and West Germany -- or "interzonal trade" (IZT) -- developed after 1948 in spite of mutual hostility. East Germany collaborated in IZT because it needed the trade; West Germany, because it wanted to hold on to East Germany. IZT has risen to about \$700 million annually. It represents about one-tenth of East Germany's total foreign trade and one-half of its trade with the industrial West.

East Germany has outgrown, however, any dependence on IZT for "strategic" products such as high-grade steel and special chemicals, and changes in West German consumption patterns and tax laws have reduced East Germany's unique advantages in the West German market. As a result, the regime has shown less and less readiness to cooperate with West Germany except on a "state-to-state" basis -- a basis which the West German government is not about to accept.

West Germany has tried to placate the East German regime by dropping the restrictions that long surrounded IZT. Although IZT no longer gives Bonn a hold on East Germany, it is a link between the two Germanies, and West German leaders are eager to maintain and stimulate trade for this reason.

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West Germany probably will be disappointed in its hopes for expanding IZT. For one thing, it is becoming harder for East Germany to increase exports, because of a lack of suitable manufactured products. Further, the East German regime believes that a stagnation or decline in IZT will be an effective way of bringing pressure on West Germany to make political concessions leading toward recognition. On the other hand, the accommodating policy toward East Germany that was followed in 1967 by the Kiesinger government has made a favorable impression elsewhere in Eastern Europe and has helped to isolate East Germany in its implacable hostility toward Bonn. The Kiesinger policy is thus an important contribution to the *Ostpolitik* urged by Foreign Minister Willy Brandt and All-German Affairs Minister Herbert Wehner, aimed at getting the Eastern European countries to establish closer relations with West Germany.

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The Rationale of Interzonal Trade (IZT)

1. Trade between East and West Germany has been conducted under arrangements that do not require West Germany to acknowledge the existence of an East German state. For West Germany the trade is not "international" but "interzonal," and the East Germans themselves long acknowledged this distinction.* Indeed, the distinction is made in the basic trade charter -- the Berlin Agreement of 1951 -- which provides for the conduct of trade between the two "currency areas" (including West Berlin in the "currency area" of the West German Deutsche Mark, or DM). West Germany has been represented, not by a government official, but by a "trustee" with offices in West Berlin.

2. The Berlin Agreement also narrowly restricted the conduct of trade. Under its provisions, which were not modified until 1960, only articles included on annual commodity lists negotiated by the partners could be exchanged. Many commodities were subject to quota restrictions, and licenses were required for all shipments. Trade was carried out under five subaccounts (designated, illogically, 5, 6, 7, 8, and A). The commodities included in each subaccount were the same for both sides, and each account had to be balanced separately -- surpluses in one account could not be used to cover deficits in another. This rigidity was modified in only one way -- each subaccount had provision for a small "swing" -- the amount of imbalance permitted. If the "swing" limit was reached in one of the accounts, the authorities in the creditor area ceased to grant shipment licenses, and trade in that account was effectively stopped until the other side could export enough to bring the account back within the "swing" limits. Payment was handled through a complex system of parallel accounts in the state banks of the respective "currency areas," and there was no provision for cash transfers between the

* The East Germans called it "intra-German trade" (innerdeutscher Handel) until 1961, when they shifted to "trade with West Germany" and, separately, "trade with West Berlin."

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banks. The debtor, therefore, could not make cash payments to cancel "swing" deficits and maintain trade.*

3. The East Germans reluctantly accepted these restrictive arrangements because they needed the trade. Trade with West Germany had dropped to almost nothing after World War II, and the USSR could only in small part replace West German deliveries of essential industrial materials, much less supply spare parts for old German machinery. Moreover, although the Berlin Agreement restricted trade with West Germany, it did allow East German products to enter the West German market without crossing tariff barriers. In the case of brown coal and synthetic fuels, which long accounted for about one-third of East German deliveries, IZT extended the benefit of West German domestic subsidies.

4. In spite of the economic benefits that would accrue to East Germany, the West German government was prepared to facilitate trade for two reasons. First, the West Germans hoped that a flourishing trade would serve to reestablish some degree of economic interdependence between East and West Germany, thus easing eventual reunification and preventing complete absorption of the East German economy into the Soviet Bloc. Second, trade was expected to help assure West German access to West Berlin. From the beginning of negotiations, the West Germans asserted that trade depended on access. Although the East Germans refused to accept such a connection, IZT had in fact been suspended during the early 1950's in cases of serious interference with Berlin access.

5. Thus both Germanies, for different reasons, favored the rapid growth of trade between them. Although IZT dropped from \$177 million in 1950 to \$68 million in 1951 as a result of renewed difficulties over access to Berlin, it rose rapidly

* In 1958 a special account "S" was established to permit East German purchases outside of the subaccount system against payment in West German DM.

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thereafter, reaching \$496 million by 1960. It then represented about 50 percent of East Germany's trade with developed countries in Western Europe and overseas and about 10 percent of its total trade. Even so, it represented only about 2 percent of West Germany's foreign trade.

The Supplementary Agreement of 1960

6. In 1960 the West Germans eased those specific restrictions in the Berlin Agreement that the East Germans had most vigorously attacked. A supplementary agreement, signed in August 1960, made IZT much more advantageous for the East Germans. The five subaccounts were consolidated into three. Subaccount I, the so-called "strategic" account, contained industrial raw materials, including the hard coal and iron and steel on which the East German economy was so dependent, and machinery and equipment. Also included in this account, however, were East Germany's most important deliveries at that time, brown coal and synthetic fuels (fuels made from brown coal by the Fischer-Tropf hydrogenation process). This new arrangement permitted East Germany to pay for a much larger volume of imports of key commodities than the more restricted account system had allowed. The "swing" limit for the "strategic" account was also raised, to \$25 million. Subaccount II was made up largely of consumer goods and agricultural products, most with no value limits. These were regarded as "nonstrategic" commodities, not essential to the operation of the East German economy. Subaccount III was for services. The combined "swing" for Subaccounts II and III was set at \$25 million.

7. The supplementary agreement also retained special subaccount "S" (set up in 1958) under which the East Germans could make cash purchases outside the regular quotas. In addition, the East Germans obtained a commitment that the Bonn government would not cease issuing delivery permits when the "swing" limits were reached. In exchange for this concession the East Germans made their only counterconcession -- agreement to the establishment of an annual cash settlement of the outstanding "swing" balances

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within a month after 30 June. Finally, the validity of the current commodity lists was extended indefinitely and contracts extending over one year were allowed for the first time, so that IZT would fit more easily into the East German system of long-term planning. These modifications did not, of course, satisfy the basic East German objection to the West German treatment of IZT as "interzonal" rather than foreign.

West German Threat to Cancel IZT

8. Before the supplementary agreement could produce the expected rise in IZT, a sudden political conflict resulted instead in a cutback in trade and in a reduction of East Germany's dependence on West German deliveries. On 30 September 1960, in retaliation for new East German restrictions on travel between West Germany and West Berlin, the West German government announced its intention not to renew the IZT agreement in 1961. The West German government thus reasserted in the most dramatic way that IZT depended on undisturbed access to Berlin.

9. In East Germany the threat to cancel the IZT agreement produced frantic attempts to line up alternative supplies for the essential imports involved. These efforts made clear to the East Germans their vulnerability to West German pressure. Realizing the weakness of their position, the East Germans entered into negotiations, determined to prevent the collapse of IZT at the end of 1960 and to reinstate the supplementary agreement negotiated in August. The West Germans, literally at the eleventh hour, 29 December 1960, agreed to allow the August agreement to come into force on 1 January 1961 as planned, thus preventing an interruption in trade.

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10. In March of 1961 the West German government also introduced an internal system of revocable delivery permits, which -- as stated in the permits themselves -- could be canceled in case of East German interference with Berlin access. This device, although bitterly resented by the East Germans, apparently was introduced to provide a legal basis for insurance guarantees to West German shippers in case trade was interrupted, rather than to bring pressure on the East Germans.

Reduction of East German Dependence on IZT

11. The West German government was well satisfied with the results it got by threatening to cancel the IZT agreement. But it was a hollow victory. The East Germans, humiliated, proceeded to accelerate their already planned attempts to end their economic dependence on West Germany. East Germany had been strengthened enormously since the mid-1950's by Soviet economic and political support. The regime was in a position to reduce greatly its vulnerability to a cutoff of IZT by building up inventories and by assuring alternative sources for high-grade steels and a number of specialized chemicals. Although the first step, a crash program to reduce the use of West German products, was not successful, the measures taken to increase imports of steel and chemical products from other countries began to bear fruit in 1961-63.

12. The effects of the East German campaign to attain economic independence from West Germany became visible in a drop in IZT in 1961-62, and, still more significantly, in a shift in the commodity structure of West German deliveries. The volume of trade, which had reached \$496 million in 1960, dropped to \$442 million in 1962* and did not regain the 1960 level until 1964. Steel and machinery and equipment (which had constituted about one-third of deliveries in the late 1950's) fell as a share of West German deliveries, while foodstuffs and agricultural products

* *The decline in IZT from 1960 to 1962 is somewhat understated by the use of dollar values. The dollar value of the West German mark (DM) was raised by 5 percent in 1961 (as of 6 March), with little or no effect on prices in IZT.*

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rose. In 1964, when total West German deliveries again began to rise sharply, East German orders for foodstuffs continued to expand (with some changes in composition). Imports of chemical fertilizer and machinery and equipment also increased, but orders for high-grade steel continued to decline. As a result of these structural changes and the increases in East German production and in imports from other sources, West Germany provided a greatly reduced share of the total East German supply of key commodities, especially high-grade steel,* that are essential to maintain current industrial production.

13. At the same time that East Germany was deliberately reducing its dependence on IZT, changes in the West German market were making the trade less advantageous to East Germany. A large share -- in the late 1950's, about one-third -- of East German earnings in IZT had been obtained by deliveries of brown coal briquettes and of gasoline and diesel fuel, all valued at the high subsidized prices of the West German domestic market. East Germany earned more than twice as much from these deliveries as it would have earned from exports to other Western European markets. In the 1960's, however, deliveries of brown coal briquettes -- used mainly for domestic heating -- began falling as a result of a shift from coal to oil and gas in West Germany. Although the demand for East German gasoline and diesel oil remained strong, earnings dropped sharply in 1964, when West Germany, in accordance with Common Market agreements, eliminated subsidies for synthetic fuel production, from which East German deliveries had benefited. For one year, in 1964, West Germany made special compensation to East Germany for the elimination of the subsidies, but in 1965 the West Germans refused to extend the compensatory payments. In 1967, East Germany finally cut off deliveries of gasoline and diesel fuel.

14. With its need for and gains from IZT having been reduced, the East German regime was ready by 1965 to refuse to conduct any trade negotiations

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with West Germany except on a political level. The regime was not eager to sacrifice the trade itself, so long as continuation of the trade did not require new formal agreements through the old channels. But, as became clear, no economic concessions that West Germany could offer would buy any sort of political *quid pro quo* from the East German regime.

West German Moves to Stimulate IZT

15. The West German position on IZT has also evolved in the 1960's in response both to East German policy and to changes in domestic politics and the international situation. Wishing to preserve this vestige of a united Germany, the West Germans have become increasingly concerned over the future of IZT and more willing to make major unilateral concessions in the hope of stimulating the trade. As a result of the deliberate East German cutback in IZT in 1961-62 and the accompanying rise in East German imports both from the USSR and from various Western European countries, both business and political circles in West Germany began to fear the loss of their special position in the East German market. The continued drop in East German imports of high-grade steels and special chemicals even in 1963-64, when IZT once again began to grow, gradually convinced most West Germans that IZT was no longer a weapon of much value in assuring access to Berlin. Moreover, there was increasing popular and official desire to insure the growth and importance of the trade as one of the few remaining links between the two parts of the divided Germany.

16. The changing political climate in West Germany, against a background of apparent detente in the cold war, turned these sentiments into official policy after 1965. The process began while Ludwig Erhard was Chancellor and has accelerated since the Social Democrats finally took office as members of the "grand coalition." Under the prodding of Willy Brandt, Minister for Foreign Affairs, and Herbert Wehner, Minister for All-German Affairs, the Kiesinger government has gradually moved to eliminate most of the specific provisions in IZT arrangements to which the East Germans have so long objected. Bonn has shown a growing readiness even to deal with East Germany through responsible West German government officials.

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17. Most of the West German concessions have come since 1965. The only earlier concession of significance was the decision of the Bonn government not to enforce the cash settlement provision of the August 1960 agreement and the postponement of the 30 June settlement date in every year except 1963 (when the balance was less than \$1 in favor of East Germany).

18. The first major concession came in June 1965, when \$12.5 million was transferred from the East German surplus balance in Subaccount II to cover part of the East German deficit in Subaccount I. Similar transfers were made in January and February of 1966. In this way the East Germans were allowed to use their expanded deliveries of consumer goods (largely clothing and textiles) and agricultural products (sold at the high West German domestic prices) to offset increased purchases of hard goods, particularly machinery and equipment. The logical extension of this practice was simply to abolish the subaccounts altogether, as West Germany did in 1967, thus removing a major limitation on the value of the trade to East Germany.

19. Another step taken by West Germany to encourage IZT was the development of special machinery for extending medium- and long-term credits to East Germany, through the so-called Financing Company for Industrial Facilities.* This move was more welcome to West German businessmen than to the East German regime, which in general rejects special features distinguishing IZT from other trade. West German banks have been hesitant to finance capital exports to East Germany, and the West German export guarantee organization -- Hermes Kreditversicherungs A.G. -- is not authorized to guarantee credits to a state still unrecognized by West Germany. In the absence of these facilities, West German businessmen have to a considerable extent been financing their own exports to East Germany, and by the beginning of 1967 private unguaranteed credits in IZT were estimated at more than \$75 million. The West Germans have also established provisions for the

* Gesellschaft zur Finanzierung von Industrieanlagen mbH., or GEFI.

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German Audit and Trust Company* to guarantee loans granted to East German purchasers by West German suppliers, acting in the same manner as Hermes.

20. Other West German measures taken to encourage IZT have been (1) to drop the "revocability" clause in export and import licenses and (2) to expand the quotas for East German deliveries of hard goods directly competitive with West German products -- including iron and steel, vehicles, machinery, and electrical and technical equipment. The West German government has also ruled that the "value added" tax applicable in internal trade will be remitted in the case of East-West German trade.

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Prognosis for IZT

22. The West German attempts to liberalize IZT are intended above all to increase trade. Their effect depends in part on the ability of the East Germans to expand their exports but even more on how much the regime wants to increase trade.

23. It is unlikely that East German exports to West Germany can increase rapidly in the next few years. The East Germans have been largely unable to adjust the production of machinery and equipment, the items that they are most anxious to export, to the needs of the West German market. The technology of most East German machinery is obsolescent by Western European standards, quality is frequently poor, and sales and servicing facilities, although improving, are still inadequate.

24. Although East German deliveries of consumer goods have risen by about 8 percent a year since 1960, this growth probably will not continue. Supplies

* *The Deutsche Revisions und Treuhand A.G., whose main function is to audit government accounts.*

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available for export are limited by increasing domestic demand and by the demands of the Soviet Union and East Germany's other Eastern European trading partners. Also, the market for these goods in West Germany tends to be erratic, the East German distribution and sales system is not well developed, and most sales must be made at prices averaging about 20 percent below the prices for comparable West German goods.

25. East German shipments of agricultural products, particularly grain, have risen sharply (in 1966 they amounted to 27 percent of total East German deliveries, compared with 10 percent in 1960), but are likely to level off. The East Germans may still be in a position to increase these exports substantially, but a continued rapid rise in West German imports of agricultural commodities would almost surely bring protests from the other members of the European Economic Community (EEC), which have already expressed some concern that IZT is being used as a means of evading the common external tariff.

26. With the successive removal of specific East German objections to the IZT Agreement, the East Germans have shifted their ground to new, more openly political issues. In pressing their claims for compensation for the elimination of petroleum subsidies in 1964 and for payment of postal and other service charges, claims which the West Germans have already accepted in principle, they have attempted to upgrade the political level of negotiations. Thus East Germany has refused West German offers of compensation for the petroleum subsidies because the offers were made within the existing IZT framework -- the "currency area" formula. East Germany also has insisted on bypassing the special IZT "trustee's" office in the negotiations over the amount of future service payments. The West German Ministries of Post and Telecommunications and Transport have already addressed unprecedented communications to their East German opposite numbers proposing technical-level discussions on the service payments issue. The East Germans have rejected these communications, implying that the discussions must be at the ministerial level. Since even partial payment of these compensation claims would eliminate or substantially reduce East Germany's current IZT deficit -- a major obstacle to further increases in trade -- the West Germans probably will accede to the East German demands.

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27. The ultimate aim of East German IZT policy is to transform the special relationship embodied in the current institution of East-West German trade into normal foreign trade and if possible to replace the Berlin Agreement with a true government-to-government trade agreement. For this political gain they would have to pay a price, because such an agreement would entail significant economic losses for East Germany. Since IZT is treated as internal trade by West Germany, East German goods enjoy tariff-free treatment, making them more competitive on the West German market than elsewhere. A government-to-government agreement would transform East-West German trade into ordinary foreign trade, and the tariffs that apply to West German imports from other markets would have to be imposed on imports from East Germany. West Germany's other trading partners, particularly those in the EEC, clearly would be unwilling to continue the special exemptions for IZT that were included in the General Agreement on Tariffs and Trade (GATT) and the Treaty of Rome. If IZT were to be conducted under the same competitive conditions as West German trade with the rest of the world, East Germany's current difficulties in expanding exports in competition with West Germany's other trading partners, particularly with those in the Free World, would be substantially increased. Under these circumstances it would be difficult for the East Germans to maintain even their current level of exports, and IZT might even fall. Clearly, the East Germans consider a decline in IZT a small price to pay for the recognition inherent in a government-to-government agreement; such a decline, however, is precisely what the West Germans are attempting to prevent.

28. It is unlikely that the Berlin Agreement will be replaced in the near future by a government-to-government agreement. Although All-German Affairs Minister Wehner and possibly Foreign Minister Brandt may personally favor an agreement of that sort, Chancellor Kiesinger and the CDU (Christian Democratic Union) generally would probably be unwilling to accept such a degree of recognition for East Germany at this time. The East Germans, however, will continue to press for a government-to-government agreement that would amount to *de facto* recognition. They are perfectly willing to allow IZT to stagnate if they feel that standing pat will bring them closer to their goal. Not unless they are convinced

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that no further political gains in IZT are possible will they attempt to maximize the economic gains to be had from increased trade with West Germany.

29. The significance of recent developments in IZT must be evaluated in the broader context of West Germany's policies toward Eastern Europe as a whole, as well as in terms of East-West German contacts. Extending *de facto* recognition to East Germany in the economic sphere would undoubtedly assist the efforts of the Bonn government to improve relations, and trade, with the rest of Eastern Europe. West German trade with Eastern Europe (excluding IZT) has risen at an annual rate of more than 10 percent since 1960, and Eastern Europe is still regarded by most West German businessmen as an untapped market. Most of these countries have clearly indicated their interest in increased contacts with West Germany, and only strenuous Soviet and East German political pressure has prevented Czechoslovakia, Hungary, and Bulgaria from following the Rumanian example and establishing full diplomatic relations with Bonn. *De facto* recognition of East Germany in trade relations with West Germany would reduce the political pressure that the Ulbricht regime could bring to bear on its Warsaw Pact allies, and might trigger the long-sought breakthrough in West German *Ostpolitik*.

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